

June 2004

Political Amends

Post April 15th, a tax preparer's thoughts turn to . . . getting it right. During the busy-ness of those wild and wacky months called tax season, it is easy to make mistakes, even for those whose returns will be under public scrutiny. Case in point: the tax return for Senator John Kerry for 2003. There is a website, www.taxhistory.org, which posts the returns for the President and Vice President, former Presidents, and the current candidates. Senator Kerry's return was posted during April. A CPA from Denton, Texas, Bob McCombs, wrote in to Tax Analysts (a tax research service) about a mistake he found on the return and he was exactly right! Consequently, the accounting firm for Senator Kerry filed an amended return. The original return and the amended return are both posted on the website, www.taxhistory.org. It makes for fascinating reading.

What was the error?

It is an easy error to make and it goes to the heart of the complexity of the tax system. Senator Kerry sold a 1/2 interest in an Adam Willaerts painting. He paid \$500,000 for it and he sold it for \$675,000, resulting in a gain of \$175,000. This is the sale of a capital asset and since it was held more than one year it is a long-term capital gain. It is properly reported on Schedule D. So far, so good. The sale took place during March, 2003. The original return showed that the gain is taxed at 20%, the rate that did apply to long term capital gains during the beginning of the year. However, sale of artwork is sale of a collectible, and the capital gain rate on collectibles is 28%. This 28% rate is still the law, even though sales of assets in 2004 are subject to a maximum capital gains rate of only 15%, and the rate could actually be as low as 5%. Collectibles, however, have a 28% rate of tax imposed on their gain. The explanation on the 1040X, the amended return, states that "The tax on the sale of the one-half interest in the Adam Willaerts painting was inadvertently calculated at the 20% rate rather than the 28% rate." It is not possible to state whether this error would have been caught and corrected had it not been for that very accurate letter from the CPA in Texas.

Do you need to make amends?

Even politicians sometimes have to make amends. If you have any amends to make on your taxes, let the office know. Perhaps you mistakenly omitted providing a 1099 to the office. Maybe you forgot to claim one of your children (it's been known to happen). Filing a 1040X is used to report additional tax and it is also used to request a refund. In some events, you might even want to file a protective claim, an amended return that keeps a year open for determination (usually for a refund) by the IRS if a contingency takes place.

Anyone can make a mistake. The IRS provides you an opportunity to correct them. And you have a period of three years to do so. Senator Kerry filed the 1040X blisteringly fast. Go have a look at the returns of our politicians and remember, they are only human; they make tax mistakes just like the rest of us!

Reduced Savings on Savings Bonds

Series HH bonds to be discontinued

Holders of Series E and Series EE bonds are going to lose a tax break this fall. Beginning September 1, 2004, the owners of these bonds will not be able to trade them for Series HH bonds because the US Treasury is going to discontinue the HH bond series.

As a result owners of E or EE bonds will not be able to defer tax on the accrued interest at maturity by rolling over the proceeds into HH bonds. Owners of E and EE bonds can convert them to HH bonds prior to September 1st without triggering tax. However those who decide to do so should note that the HH bonds pay less interest than E or EE bonds

Taxation of interest income on Series EE and Series E bonds

The tax due on the increase in value of Series E and Series EE bonds (which are issued at a discount) depends on the accounting method the taxpayer uses. For taxpayers using the accrual method, they must include the increase in value each year even though the interest is not paid until the bond is surrendered. The amount of increase in redemption value is indicated in the table of redemption values which are shown on the bond.

Most individual taxpayers, however, use the cash method, and are not required to recognize as income any increase in value of the bonds that are issued at a discount until the earlier of two dates:

1. the year that the bond holder cashes in the bonds or disposes of them, or
2. the year that the bonds mature

Previous benefit of trading Series E or Series EE for Series HH

As stated above, cash basis taxpayers have been allowed to continue to defer the recognition of interest income on their Series EE and Series E bonds beyond their maturity. They were allowed to do this by rolling them into Series HH bonds, as long as no cash was received in the transaction. When the Series HH or Series H bonds finally matured (or if they were disposed), the difference between their redemption value and cost was reported as interest income. The cost was the amount paid for the Series EE or Series E bonds plus any additional amount paid for the Series HH or Series H bonds. This benefit will no longer be available on September 1, 2004 when the treasury discontinues the issuance of Series HH bonds.

Some remaining choices and benefits:

Cash basis taxpayers can still elect the accrual method for interest recognition. This election treats the increase in value of Series EE (former Series E) and Series I bonds as income in each year. This election can only be revoked with IRS consent. Also this election is not binding for a subsequent owner who purchases the bonds.

There may be occasions when a cash basis taxpayer will want to make this election. The income may be taxed at a lower rate now if the tax rates are expected to increase. The taxpayer may want to recognize the income ratably so as to avoid being taxed in a

higher bracket by aggregating the income. It may also be the case that a net operating loss or other carryforward item is expiring and can be used to offset the current accrued interest income.

Please contact the office if you need help deciding what to do with your savings bonds. Let the office assist you in maximizing your savings before it's too late.

Beware of Fraudulent E-mails

Shortly after Congress' enactment of the Can-Spam (Controlling the Assault of Non-Solicited Pornography and Marketing) Act, the Internal Revenue Service warned taxpayers about an identity theft operation that tries to elicit personal information by sending e-mails which are supposedly for a tax investigation.

Neither the U.S. Treasury Department nor the Internal Revenue Service sends e-mails to taxpayers regarding their tax accounts. If you have received an e-mail regarding your tax account, that purports to be from the IRS or the Treasury Department, beware! The only e-mails that are sent from the IRS are e-News subscriptions which are sent only to those who register for the service via the website interface.

How the operation works

These e-mails falsely claim that the recipients can dispute an impending, tax fraud charge by registering personal information on a web site. The site asks for detailed personal information such as your Social Security number, credit card account numbers and driver's license number.

With all this personal information, identity thieves can create fake identification documents and use them to set up credit card accounts or other services at the victim's expense.

Protect yourself

To protect yourself from identity theft, you should obtain a copy of your credit report and review it for any suspicious activity. Listed below are three major credit bureaus and each has its own fraud department. You can contact one of them and even ask that your file be flagged with a "fraud alert tag" and a "fraud victim statement." This precaution limits a thief's ability to open new accounts under your name since the creditors will have to call you before granting credit. You should check your credit at least once a year to make sure your credit history is in order.

Equifax
(800) 525-6285
www.equifax.com

Experian
(888) 397-3742
www.experian.com

Transunion
(800) 916-8800
www.transunion.com

Taxpayers who receive suspicious e-mails regarding their tax accounts should contact the U.S. Treasury Department at (800) 366-4484 or the IRS at (800) 829-1040.

Tax Doggerel

Doggerel means verse, of a humorous or burlesque nature. Right outside of tax season, I like to share some tax humor with you and our tax humor comes from a wonderful case, Herold L. Jenkins v. Commissioner. Some of you might recognize the name Herold L. Jenkins, especially if you are a deep country music fan. Mr. Jenkins performed under another name, a more recognizable one: Conway Twitty. Mr. Jenkins formed a chain of fast food restaurants called "Twitty Burger" and raised money from fellow country singers; unfortunately, the restaurant business went belly up. Mr. Twitty, although under no legal obligation, personally paid back all of the investors who put up money for the restaurant business. Understand that the restaurant business was a corporation, and a corporation is a separate and distinct entity from an individual taxpayer. Mr. Jenkins deducted the payments as ordinary and necessary, under Code Section 162, which does permit a deduction for business expenses which are ordinary and necessary. The court case is longer than the space we can allocate to it in this brief article, but the court did side with Mr. Jenkins and did allow the deduction. Ah, but in footnote number 14, the court turned writer of country western music and nicely summarized their decision using musical doggerel. Here is their lyric, you can provide your own guitar accompaniment.

"Ode to Conway Twitty"

Twitty Burger went belly up
But Conway remained true
He repaid his investors, one and all
It was the moral thing to do.

His fans would not have liked it
It could have hurt his fame
Had any investors sued him
Like Merle Haggard or Sonny James.

When it was time to file taxes
Conway thought what he would do
Was deduct those payments as a business expense
Under section one-sixty-two.

In order to allow these deductions
Goes the argument of the Commissioner
The payments must be ordinary and necessary
To a business of the petitioner.

Had Conway not repaid the investors
His career would have been under cloud
Under the unique facts of this case
Held: The deductions are allowed.

When a court opinion comes out, the IRS can agree or disagree. The IRS disagreed with the decision, but they also penned lyrics which are equally singable, unless you choose to yodel them (my preference!).

"Ode to Conway Twitty: A Reprise"

Harold Jenkins and Conway Twitty
They are both the same
But one was born
The other achieved fame.

The man is talented
And has many a friend
They opened a restaurant
His name he did lend.

They are two different things
Making burgers and song
The business went sour
It didn't take long.

He repaid his friends
Why did he act
Was it business or friendship
Which is fact?

Business the court held
It's deductible they feel
We disagree with the answer
But let's not appeal.

Krebs Advisory Group hope's that all of your tax concerns are a tuneful song. When you have a tax issue, please ask us to join you. We promise to provide you all the back up harmony you'll need.

Very Truly Yours,

Krebs & Co., CPA's, Inc.
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